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MEMORANDUM FOR: Assistant NIO for Latin America

SUBJECT : Review of Panama's Economy

Attached is the review of the economic situation in Panama which you requested for inclusion in the briefing paper for Ambassador-Designate Jorden.

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[redacted]

Acting Chief
North America/Caribbean Branch

Attachment:
As stated

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Background

With an area of 30,000 square miles and a population of about 1.5 million, Panama is slightly larger and slightly less populous than West Virginia. It has few natural resources, although mining of copper ore is scheduled to begin shortly and the possibility of finding offshore oil deposits is being explored on both the Atlantic and Pacific sides. Its primary natural asset is its geography, which permitted construction of the internationally important canal that forms the hub of Panama's economic activity. More than one-third of the population, two-thirds of the national income, and nearly all manufacturing, trade, and public services are concentrated in the areas immediately adjacent to the Canal Zone, mainly in the terminal cities of Panama City and Colon.

Agriculture still is the most important sector of the Panamanian economy, producing 17% of GDP, furnishing livelihood to 40% of the population, and accounting for about two-thirds of all exports. As in other Central American countries, there are two distinct types of agriculture: modern, efficient, export-oriented operations and the traditional, inefficient, subsistence farming practiced by peasants who have limited access to modern technology and investment funds. Manufacturing, although it now accounts for about the same share of GDP as agriculture, consists of relatively small-scale enterprises. Food processing is the chief manufacturing activity, although the most important production plant, in terms of output value, is the country's single refinery at Bahia las Minas outside Colon. Construction and banking are rapidly growing sectors of the economy.

The Canal Zone and the Colon Free Port at the Atlantic end of the Canal are important to Panama's economy. Salaries and wages paid to Panamanians and purchases of Panamanian goods and services by private individuals and organizations and by US government agencies in the Canal Zone amount to over $150 million annually, equal to more than 15% of GDP. (The Zone contributes directly more than 7% of GDP, mainly through payment of wages and salaries to Panamanians employed there.) The Zone buys about one-tenth of all electric power produced in Panama. The Colon Free Port earns foreign exchange for Panama and is the channel through which the country receives 12% - 15% of its imports.

Summary of Recent Economic Developments

Growth

Panama's economy is maintaining the generally high GDP growth, averaging about 8% per year, that prevailed throughout the 1960s. In 1971 real GDP rose 8.7%; in 1972, 7.6%. Agriculture grew less rapidly -- 3.5% in 1971 and 6% in 1972. Growth rates for both GDP and agricultural output probably were down in 1973 because of drought, floods, and disease that restricted crops generally and caused a 15% drop in banana production. Manufacturing grew by about 11% per year in 1971 and 1972, but growth slowed during the first half of 1973.

Foreign Trade

Since 1970, when they registered a small decline, exports have been growing moderately -- 6% in 1971 and 5% in 1972. Imports, however, continued the rapidly rising trend of the late 1960's, increasing 10% in 1971 and 11% in 1972. Consequently the trade deficit, which for years has considerably exceeded total exports, is widening. In 1972 it was 28% larger than in 1970. The gap increased further during the first half of 1973, as imports continued to grow more rapidly than exports, and the situation could only have worsened in the last half year as food imports increased and prices of petroleum imports rose.

Although the United States is by far Panama's largest trade partner, trade with some other areas has grown more rapidly in the past few years. Imports from the United States rose in 1972 after stagnating in 1971, and incomplete data suggest that they rose again in 1973, partly as a result of shifts in exchange rates on world money markets. Exports to the United States, however, have been steadily declining. Trade with members of the Central American Common Market (CACM) has been growing steadily and rapidly, although Panama's imports have been running three times its exports. Trade with West Germany, Panama's second largest customer, has been climbing, and a rapid growth of exports to Italy and the Netherlands has brought these countries into third and fourth place on the customer list. The Colon Free Zone is the second largest source of Panamanian imports, followed by Venezuela, which supplies mainly crude oil, and Japan, from which Panama has been importing increasing amounts of capital equipment. Panama's exports to all three of these areas are negligible.

There has been relatively little change in the composition of Panama's exports. Bananas continue to make up more than half of the total, petroleum products about one-sixth, and shrimp, sugar, meat, coffee, and fish meal most of the remainder. Among imports, manufactured goods, which make up the bulk of Panama's foreign purchases, have been growing the most rapidly. Imports of fuels and lubricants also have been rising steadily and represent about one-sixth of total imports. Food imports rose sharply in 1971 but dropped back in 1972. They apparently rose again in 1973.

Balance of Payments

Panama's sizable trade deficit, which reached almost $100 million in 1972, is balanced by growing receipts from tourism and by large inflows of capital both from private investors and lenders and from international lending institutions. Annual foreign investment declined in 1971 and 1972 from its 1970 peak of over $30 million but government borrowing and funds entering the financial sector brought net capital inflow to a record level of $137 million in 1972. More than 85% of all direct foreign investment in Panama -- $233 million out of $269 million at the end of 1972 -- is US investment. Total US investment is estimated at over $1.5 billion.

Banking

Under the banking law of 1970, banking enjoys a favorable environment and is unrestricted by currency controls such as have been instituted in most Latin American countries. For this reason, and also because the dollar is the national currency, Panama is becoming increasingly a center of banking activity. The number of banks is growing steadily. Reportedly there are now 58, two-thirds of them foreign. Approximately 15 hold licenses restricting them to operations outside of Panama, but most provide banking services to both Panamanians and foreigners. Loans totaling $2.2 billion were granted during 1972, slightly over half of them to foreigners. Total bank assets amounted to $1.9 billion at the end of that year, four times the level of 1968. A large part of the funds in Panama's banks are owned by Latin Americans, many of whom transact their international business in Panama in order to circumvent exchange or transfer restrictions in home countries.

Economic Policies and Government Spending

The Torrijos government has been much more inclined than previous governments to stimulate economic growth through government investment. Government capital spending has been particularly aimed at developing infrastructure, housing, and agriculture. Torrijos also has favored nationalization of some services, such as electric power supply and communications.

In the first years of the Torrijos regime, government investments that could not be covered by current account surplus or grants and loans from international agencies were financed by short-term foreign commercial loans. As a result, Panama soon was confronted with heavy debt service requirements. In 1970 debt service had reached $29 million. In 1971 the government began to restructure its foreign debt. New borrowings now generally have maturities of at least seven years, and several large loans have been negotiated to refinance the short-term debt. Two of these obtained from international banking consortia in 1973 -- one in January, the other in October -- totaled $180 million and enabled Panama to reduce its annual debt service from nearly 30% of the 1973 operating budget to only a little over 20% of the 1974 budget. Even so, debt service, with an allocation of $57.4 million, is tied with education for the leading position in the 1974 budget; it far exceeds the next largest allocation, for government and justice, and is more than twice the amount earmarked for health.

With its foreign debt now manageable, Panama is in a favorable position to obtain additional foreign development loans. Accordingly, it is proceeding with an ambitious five-year investment plan worked out for 1973-77. In the 1974 investment budget for the entire public sector the largest allocation -- \$71.9 million out of a total of \$315 million -- is to go to housing, a field largely neglected since 1968. Agriculture is to receive the second-largest allocation of \$60.4 million. Transportation, traditionally the primary recipient of government investment funds, dropped to second place in 1973 (when the purchase of the national electric company from Boise Cascade Company pushed power investments into the lead) and ranks third in the 1974 budget.

The government tax structure still is inadequate despite improvements made since the mid-1960s. Income taxes are the largest source of central government revenues, but their relative importance has declined since 1970. Foreign trade taxes and taxes on domestic transactions are the second and third most important revenue producers. In 1972 government revenue raising efforts shifted to excise taxes on liquor, tobacco, and gasoline. Central government revenues have increased by well over 10% per year since 1968 and have amounted to more than 15% of GDP, but additional revenue bases and improved collections both will be needed to meet future spending goals and repayment commitments. The government has made plans for new tax measures and stricter control of spending in 1974 and has acknowledged that further tax increases will be needed in 1975.

Economic Problem Areas

Dissatisfaction in Business Circles

In October 1973 announcement by the government of a package of twelve laws designed to foster construction of low-cost housing touched off an unexpected wave of anti-government sentiment among Panamanian businessmen. Torrijos' effective parrying of their initial protests and his agreement to consult with business leaders on future legislation affecting them temporarily blunted the opposition, but businessmen remain unconvinced, uncertain, and distrustful. Although only a part of the business community was directly affected by the laws, the remainder fears that the disregard of business interests implicit in the failure to consult or inform businessmen about the housing laws may portend other unilateral government moves in the future that will have a detrimental effect on business interests.

In December 1973 an anti-government organization, the National Civic Movement (MCN), was organized with the backing of the National Council of Private Enterprises (CONEP) and two dozen or so other associations and clubs representing private business and professional interests in Panama. Exactly how the MCN plans to operate is not clear, but it apparently intends to exert pressure on the government through a show of numerical strength and by threats of economic slowdown if private business interests are ignored.

The housing laws themselves do not appear to have been deliberately designed to interfere with private enterprise. The government intent seems to have been to protect tenants, especially low-income families, against rent gouging and to channel more construction funds into "social interest" -- i.e., low-cost -- housing, which is badly needed. Despite booming activity in the construction industry, housing construction, at the rate of around 6,000 units per year, has been unable to meet the needs of the increasing population and also replace the large number -- estimated at well over 100,000 -- of substandard existing units. Low-cost housing has been especially inadequate, because builders naturally have tended to concentrate efforts on the more profitable luxury residential and non-residential construction.

The new laws call for banks to commit the equivalent of 50% of savings accounts to mortgages for low-cost housing and provide for a rent rollback to the levels of December 1972 and for three-year, renewable leases. They also offer some concessions and incentives for landlords--such as payroll deductions from tenants' wages to assure rent payments and tax exemptions for certain improvements--but the landlords, as well as the construction industry and bankers, resent what they regard as unwarranted government interference in their business. Business sectors not directly affected are uneasy because they fear future interference in their own activities. Just after the announcement of the new laws there was a rash of heavy withdrawals from bank deposits in amounts variously estimated at less than $5 million, $8 million - $9 million, or over $20 million. This apparently was a short-term phenomenon based in part on the misconception that the laws would freeze some savings accounts. There was no run on the banks and no evidence of any really sizable capital flight. In the construction industry, however, the number of building permits issued has dropped, and some already approved have been allowed to lapse. Overall, the new laws probably will prove counterproductive. They appear unlikely to markedly stimulate construction of low-cost housing, and they probably will cause a contraction of other construction activity that recently has been a major source of economic growth.

The Oil Crisis

The impact of the oil crisis on Panama's economy is difficult to gauge. Panama's supply of crude oil, obtained from Venezuela, probably is not seriously threatened, but higher prices will increase the trade deficit, contribute to domestic inflation, and cause some cutbacks in industrial activity.

The cost of crude oil imports, which amounted to $68 million in 1973, could increase by $100 million in 1974. The increase would be offset to a great extent, because Panama sells nearly three-fourths of its output of petroleum products as exports and as bunker fuels and presumably will comparably raise prices of these commodities. The cost of crude imported for domestic use, however, still could increase from $28 million in 1973 to as much as $67 million in 1974. Domestic gasoline prices, which were increased 12¢ per gallon by a tax raise in early 1973, had grown by 80%

more by late January 1974, premium grade increasing from 47.3¢ per gallon to 86¢ and regular from 44.3¢ to 80¢.

Panama is exploring all available means for increasing supplies of petroleum and decreasing demand -- discussions with Algeria concerning the possibility of importing from that country, intensified offshore exploration, accelerated development of hydroelectric power, curtailment of private use of gasoline and electric power, and reductions in the amount of bunker fuel furnished to ships. It also is considering ways of increasing exports to pay for the extra petroleum costs. It has even been suggested that $15 million additional could be realized from increased meat exports if two meatless days were observed per week.

Unemployment and Inflation

Unemployment probably will rise well above the already high level of 6.8% reported for 1972. Curtailment of construction activity in the aftermath of the housing-law controversy already has decreased the demand for workers, and layoffs are likely in export-oriented production because rising prices will tend to depress the demand for Panama's exports (other than petroleum products).

Inflation is another potential source of economic difficulties. So far, however, the cost of living appears to have risen less in Panama than in most other countries. Consumer prices were up about 10% in 1973. The government has imposed rent and price controls to curb inflation, but there are certain to be further increases as world prices continue rising.

The immediate need to deal with unemployment and inflation may cause some slippage in the government program for economic development. If economic problems persist or become more severe, Panama's present good international credit standing could be undermined. For the immediate future, however, additional foreign credits probably can still be obtained rather easily.

Prospects

Without the uncertainties posed by the disaffection of parts of the domestic business community and by the world oil crisis, Panama's economic prospects would be excellent. Recent rapid growth, responsible government fiscal policies as evidenced particularly by the recent foreign debt refinancing, and current optimism concerning prospects for a new Canal treaty would be expected to generate business confidence and lead to continued strong growth.

Because Torrijos desires to avoid developments that could weaken his position in the treaty negotiations, he is unlikely to allow the business community to become so far alienated as to cause serious economic disruptions. Effects of the oil crisis are largely beyond his control, but some features of the economy probably will buffer Panama against the full effects of the crisis and of a world economic slowdown. Services to the Canal Zone and financial operations (providing the government does nothing more to undermine bankers' confidence) are not likely to drop off as much as industrial activity and export-oriented agriculture. While the 1974 real growth rate can hardly be expected to reach the high levels of the past several years, it may well reach 4% - 5% and thus remain substantially above rates in most other countries.